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The Challenge Ahead: Maintaining a Focus on Incentives to Enable Development

Public Interest Comment on the Millennium Challenge Corporation's
Report on the Criteria and Methodology for Determining the Eligibility of Candidate Countries for Millennium Challenge Account Assistance in FY 2006

Frédéric Sautet, Brian Hooks, and Daniel Rothschild

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EXECUTIVE SUMMARY

The Millennium Challenge Account's (MCA) focus on results and creating incentives for developing countries to enact good policy continues to hold promise for a well-needed change in government-driven international development assistance. The continued success of the MCA will depend on the ability of the leadership to allow the mission – to reduce poverty through growth – to guide decisions.

The *Criteria and Methodology for Determining the Eligibility of Candidate Countries for Millennium Challenge Account Assistance in FY2006* reemphasizes the MCC's commitment to economic freedom and a strong entrepreneurial environment as the driver of economic progress. However, it also contains troubling proposals for new indicators that lose sight of this focus.

With so many problems surrounding development, it is tempting to construe the MCA as a new fix-all for development. However, this will not help developing countries or the MCA. Economic development brings social benefits such as better health, a clean environment, and quality education. The MCA must continue to encourage countries to enact policies that create the conditions for economic prosperity. If, rather, it attempts to stimulate the *consequences* of development before addressing its *causes*, it is almost assured to fail on both accounts.

The process set forward to develop a new "Natural Resource Management" indicator must be reconsidered, and any new indicators must clearly demonstrate their relationship to the MCC's mission.

The MCC needs to reconsider this and similar actions proposed in the report. These actions threaten to:

- Prioritize narrow interests over economic growth and are likely to achieve neither,
- Contradict the intent of the legislation that authorized the MCA and undermine its core principles, and
- Confuse the consequences of development with the causes of development, encouraging economically harmful policy.

The importance of clearly articulating good indicators cannot be underestimated. Because of the strong incentives the MCA creates for countries who wish to become eligible to receive funds, the MCA's influence reaches far beyond the dollars it spends. Poor choices now will have severe consequences as more countries tailor reforms to the indicators MCC chooses.

This comment is submitted by the Mercatus Center at George Mason University's Global Prosperity Initiative in the public interest, with the hope that the recommendations it contains will improve the outcome of this important policy action

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Introduction

The Millennium Challenge Account, now entering its third year, is among the most encouraging innovations in government-driven international development assistance in half a century. Rejecting failed models of economic development, the Millennium Challenge Account (MCA) is based around a fundamental premise long overlooked by the development community: incentives matter.

While most of the conversation surrounding the MCA focuses on the amount and target of development aid that has been dispersed, perhaps the most significant effect the MCA will have is through its ability to incentivize sound policy in countries that wish to become eligible for MCA funds. In this sense, the MCA promises to create change in developing countries before they even receive funds. Indeed, we have already observed this in some cases.[2]

The incentives created by the MCA are articulated in the form of 16 indicators – criteria used to determine which countries will be eligible to submit proposals for funding each year. The most recent set of indicators, published in the *Report on the Criteria and Methodology for Determining the Eligibility of Candidate Countries for Millennium Challenge Account Assistance in FY 2006*,[3] improves on the previous list without moving the targets too far from where they were set by previous reports. However, there remains room for improvement. This comment seeks to provide a resource to decision makers concerned with the success of the MCA as they consider adjustments to the *FY06 Report on Criteria and Methodology* and key decisions for the MCA going forward.

We begin by reflecting on the promise of the Millennium Challenge Corporation (MCC) over its first three years and by examining how these successes relate to the challenges ahead. In the second section, we discuss the strengths of the *FY06 Report on Criteria and Methodology* and

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[2] For instance, the *Report on the Criteria and Methodology for Determining the Eligibility of Candidate Countries for Millennium Challenge Account Assistance in FY 2006* states: "[W]e are currently using the *Days to Start a Business* indicator and have seen significant improvements in the median score for low income countries: from 62 days in 2002 to 45 days in 2005."
[3] Available at <http://www.mca.gov/about_us/congressional_reports/FY06_Criteria_Methodology.pdf>. For simplicity, we refer to this document throughout as the *FY06 Report on Criteria and Methodology*.

consider how the suggested changes fit within the greater framework of the MCA. The third section offers constructive criticism of potential additions to the list of indicators which the MCC seeks to develop. We identify three reasons to reconsider the development of additional indicators such as the “Natural Resource Management” indicator proposed in the *FY06 Report on Criteria and Methodology* and to avoid the temptations of turning away from complex, yet effective indicators of sound policy in future reports: (1) These actions prize narrow interests over broad economic growth and are likely to achieve neither, (2) These actions contradict the intent of the legislation that authorized the MCA and threaten to undermine its core principles, and (3) These actions confuse the consequences of development for the causes of development and in so doing threaten to stifle economic progress. We conclude our recommendations with a cautionary note that going forward, the MCC must be careful not to overemphasize favoring concrete yet procedural measures of policy change, or it risks substituting simplicity for effectiveness.

The fundamental premise of the MCC – that people and countries respond to incentives – is sound and borne out by empirical evidence. This comment is submitted in the public interest in the hope that the information it contains can help those working to improve the MCA to better achieve its goal of enabling prosperity throughout the developing world.

I. Reflecting on the First Three Years

The Millennium Challenge Account was announced in 2003 with great fanfare and ambitious goals. The program was a follow through on President Bush’s commitment in Monterrey, Mexico a year earlier,[4] as well as an opportunity to act on the substantial gains made in development scholarship since the post-World War II inception of the Bretton Woods institutions – a set of organizations constructed around an economic way of thinking that has since been discredited by history, but that continues to dominate within the development community.

Three years later, the Millennium Challenge Corporation, the government corporation charged with carrying out this new way of administering development assistance, has done a number of things well, under increasingly difficult domestic and global political conditions.

A. MCC’s Promise

With the September 2005 release of the *FY06 Report on Criteria and Methodology*, the third report of its kind, the MCC announced a list of indicators that reflects a significant level of consistency over time regarding the standards it sets for countries seeking to become eligible for assistance.

This stability is important because the most promising feature of the MCA is the incentives it creates for reform in countries that have not yet received any actual foreign assistance under the program. For the MCA to be an effective tool for assisting countries in developing policies that

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[4] The president delivered his remarks at the United Nations Financing for Development Conference. He said, “We must tie greater aid to political and legal and economic reforms. And by insisting on reform, we do the work of compassion. The United States will lead by example. I have proposed a 50-percent increase in our core development assistance over the next three budget years. Eventually, this will mean a $5 billion annual increase over current levels.” (Available at <http://www.whitehouse.gov/news/releases/2002/03/20020322-1.html>.)

enable sustainable prosperity and growth, it needs to set stable, meaningful, and achievable targets. The fact that it has for the most part maintained focus since its inception is no small accomplishment for a new program in today's charged political environment. With very few changes to the initial set of 16 indicators, the MCC has managed to set relatively clear targets that countries may realistically strive to meet. Moreover, the process has been transparent both with regard to the potential recipient countries and with regard to US stakeholders.

With a few important exceptions, the changes the MCC has made in the indicators it has selected over the past three years have been in line with its guiding principles, which include:

1. Successful development requires a robust institutional environment,
2. Donors and recipient countries must be held to a much higher standard of accountability when administering development funds, and
3. The only true path to development is an indigenous one – no amount of good intention or money will force a change upon a people in which they are unwilling to actively participate and for which they will not take ownership.

The significance of this shift in thinking must not be underestimated. It has become a truism to decry the failure of half a century of foreign aid, but this realization has done little to change the behavior of policymakers charged with administering assistance to developing countries. Indeed, despite this realization, we have seen much more of the same than even the most generous reading of the record would indicate is appropriate.[5]

While dysfunctional governments have become increasingly better at gaming the system, their impoverished citizens have borne the brunt of these mistakes.[6]

The MCC is among the first and certainly the most earnest attempts to correct course and learn from the mistakes of the past. The day-to-day reality of the MCC, however, still has a long way to go to catch up with its promise, and the MCC faces several crucial challenges in the months and years ahead.

B. Challenges Ahead

Washington business-as-usual has taken its toll on MCC funding. After three appropriations cycles, the MCC's FY06 budget is on track to be about 65 percent smaller than initially suggested by President Bush in 2002.[7]

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[5] US ODA increased in real terms every year between 1997 and 2004, from $9.15 billion to $19.00 billion in nominal terms. (OECD DAC statistics available at <http://www.oecd.org/dataoecd/43/24/1894385.xls>; OECD "Preliminary Official Development Assistance [ODA] by donor in 2004," available at <http://www.oecd.org/document/7/0,2340,en_2649_34447_35397703_1_1_1_1,00.html>.)

[6] Indeed, sub-Saharan Africa has become poorer on a per capita basis over the last quarter century, with real per capita GDP shrinking by 1.2 percent in the 1980s and 0.5 percent in the 1990s. (World Bank, *Global Economic Perspectives 2005: Trade, Regionalism, and Development* [2004], pg. 41.) Only now is sub-Saharan Africa returning to a level of prosperity it enjoyed in the early 1970s. Overall growth is not the only negative trend; the incidence of poverty in sub-Saharan Africa actually grew between 1990 and 2001. (World Bank, *Global Monitoring Report 2005: Millennium Development Goals: From Consensus to Momentum*, pg. 2.) This is indeed a worldwide phenomenon: contrary to the "convergence theory" of development, Lant Pritchett found that "from 1870 to 1990 the ratio of per capita incomes between the richest and poorest countries increased by roughly a factor of five…." (Lant Pritchett, "Divergence, Big Time," *Journal of Economic Perspectives* 11 [Summer 1997], pp. 3-12.)

Since the MCC requires eligible countries to shoulder the responsibility of preparing proposals for funding, its funds are dispersed when promising proposals are complete.[8] As we have learned after two funding cycles, this does not necessarily coincide with the federal budget cycle, and appropriators see budgets that have not been fully spent by September 30 as a missed opportunity to allocate elsewhere.

These factors, combined with increasing budget pressures on foreign assistance programs and across the federal government in general, have led to two years of less-than-expected appropriations for the MCC.[9]

In FY04 total US non-military foreign assistance amounted to $33.6 billion,[10] of which the MCA received only three percent. In FY05, Congress appropriated only 60% of President Bush's $2.5 billion request for the MCA,[11] and it is highly unlikely that the MCC will be fully funded in FY06.

The leadership of the organization now stands at an important decision point. They can either choose to play the appropriations game and rush whatever money remains in their accounts out the door by the end of each fiscal year, or hold firm to their founding principles and only fund those programs that they believe have a chance of being successful.

We would suggest that this is a choice between short-term expediency and long-term survival. While a decision to fully spend each fiscal year's appropriation within that year may bolster the case for higher levels of funding in the short term, the sacrifice this will entail in terms of the quality of the programs funded, and therefore the certainty of the investments, threatens the sustainability of the MCC and the model of development assistance it embodies.

As the leadership of the MCC weighs this decision, they will necessarily consider whether it is better to be successful on a smaller scale or risk failing big. The dismal track record of large levels of development spending makes the second option all the more likely should they choose to empty their accounts by next October.

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[7] As of the first day of FY06, Congress has not passed a foreign operations appropriations bill, so the actual amount appropriated to the MCC is, as of this writing, unknown. However, the House and Senate versions of the foreign operations bill (HR 3057) propose $1.75 billion and $1.80 billion for the Corporation, respectively, which is about 40% less than the administration's request of $3 billion.

[8] The MCC does, however, have the authority to provide financial and technical assistance to countries in preparing their proposals.

[9] In FY04, the President requested and Congress appropriated $1 billion for the MCA. However, in FY05, the President's request of $2.5 billion was only 60% funded. Assuming that $1.8 billion is appropriated this year, the MCA will only have received 66% of the President's requests over its first three funding cycles. (Millennium Challenge Corporation, *FY06 Budget Justification*; Millennium Challenge Corporation, *FY05 Budget Justification*; *Budget of the United States of America, FY05*.) It is also important to note that the President's budget request for FY06 is less than the $5 billion originally proposed in the Monterrey address. (Available at <http://www.whitehouse.gov/news/releases/2002/03/20020322-1.html>.)

[10] Larry Nowels, "Foreign Aid: Understanding Data Used to Compare Donors," Congressional Research Service Report to Congress RS22032 (May 2005).

[11] Millennium Challenge Corporation, *FY05 Budget Justification*; *Budget of the United States of America, FY05*.

To be sure, congressional appropriators have a significant role to play in this decision, as the MCC leadership will be hard pressed not to follow the choice signaled by Congress. However, the MCC must aggressively make its case for spending at a responsible pace to Congress and explain why it is more than just another development funding program.

C. Maintaining Mission Focus

The MCC also must battle the myriad groups that see the organization as a new trough from which to feed their various interests. Part of the real promise of the MCC is its narrowly defined mission: to reduce poverty through economic growth. The MCC was not intended as another tool with which to carry out the geopolitical goals of the State Department or to satisfy every concern associated with development.

Holding the line to this mission that Congress and the President intended in authorizing the MCA is another significant challenge facing the leadership at the MCC and those in Congress charged with its oversight.

This factor, combined with the challenge of securing adequate appropriations, make for a particularly difficult situation. But if the MCC begins to behave like the development organizations it was established to supplement, appropriators will likely be tempted to question why they are being asked to fund so many organizations tasked with such similar goals. And they will be correct to do so.

We would suggest that resisting the push by special interests to address goals beyond its mission and staying true to legislative intent is a crucial long-term survival issue for the MCC.

II. Steps in the Right Direction

A. Entrepreneurship Matters

In the *FY05 Report on Criteria and Methodology*,[12] the MCC signaled its intention to consider additional measures of government policies to foster entrepreneurial activity and develop private ownership. As we explained in our 2004 comment, private property rights and entrepreneurship are the engines of development.[13] It is only through the clear political commitment to establish and enforce private property rights and offer a hospitable entrepreneurial environment that countries develop and grow.

The *FY06 Report on Criteria and Methodology* takes a step in the right direction on this front. First, it recognizes the importance of entrepreneurship and includes a “Cost of Starting a Business” indicator. Second, it emphasizes that incentives are important not only to individual entrepreneurs but also to policymakers.

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[12] Available at <http://www.mcc.gov/about_us/congressional_reports/Report%20to%20Congress%20on%20Criteria%20and%20Methodology%20FY051.pdf>.

[13] Peter Boettke, Paul Aligica, and Brian Hooks, “The Millennium Challenge Account: Property Rights and Entrepreneurship as the Engine of Development,” Comment submitted to the Millennium Challenge Corporation (April 2004), available at <http://www.mercatus.org/pdf/materials/647.pdf>.

The “Cost of Starting a Business” indicator is superior to the “Country Credit Rating” indicator because it provides a better measure of a key component of the entrepreneurial environment. Entrepreneurial activity is made of both (a) the discovery of a potential business activity and (b) its exploitation. Costs imposed by regulation and legislation can undermine entrepreneurial activity at both levels by reducing the likelihood that business opportunities will be noticed and by making their exploitation too onerous.

Moreover, the “Cost of Starting a Business” indicator is a good addition to the set of indicators used to measure countries’ adherence to the “Encouraging Economic Freedom” policy category. A battery of six indicators will now be used to measure policies which create the conditions for economic prosperity.

The addition of the “Cost of Starting a Business” indicator to a list which already includes indicators for “Regulatory Quality” and the “Days to Start a Business” is a welcome move. As a result, the “Economic Freedom” category is now, appropriately, a much more complete picture of the entrepreneurial environment in candidate countries.

But there is room for improvement on this front. As the scholarly community catches up with the demands of policy, new and more accurate measures of the overall entrepreneurial environment are likely to emerge. It is crucial that the MCC not back down from articulating its goal to improve the indicators on this margin, as it has now emphasized for the last two years.[14]

B. Incentives Matter

The *FY06 Report on Criteria and Methodology* emphasizes the incentive effects of the MCA indicators. It states that, according to the World Bank Group, 80 percent of the business start-up reforms recently observed may be attributable to the incentives created by the MCA indicators, specifically the inclusion of the “Days to Start a Business” indicator in the “Economic Freedom” category.[15] The indicators create a beacon of good policy for countries that want to qualify for MCA assistance. Profound reforms that set countries on the path to prosperity by encouraging economic freedom can happen before any funds are dispersed. The compacts that result could turn out to be far less important than the policy changes countries undertake to qualify for MCA assistance.

But this is a double-edged sword. Just as well-articulated indicators will create productive incentives, poorly selected indicators create incentives for countries to choose unwise and potentially destructive policies. This makes the selection of indicators all the more important.

[14] *FY05 Report on Criteria and Methodology*.

[15] Reported by the Millennium Challenge Corporation, *Report on the Criteria and Methodology for Determining the Eligibility of Candidate Countries for Millennium Challenge Account Assistance in FY 2006*.

III. Key Challenges Ahead: Concerns with the FY06 Criteria and Methodology

As the MCC continues to refine eligibility criteria, it is important that it remain true to its mission and stay above the political fray. The Millennium Challenge Act of 2003 was passed in order "to provide [global development] assistance in a manner that promotes economic growth and the elimination of extreme poverty and strengthens good governance, economic freedom, and investments in people."[16] To the extent that the MCC deviates from this mission, it becomes redundant, less likely to succeed in its mission, and politically susceptible. Several aspects of the *FY06 Report on Criteria and Methodology* suggest a direction that, unless corrected, may lead down the path of mission creep and ineffectiveness.

A. Confusing the Consequence with the Cause of Development

The MCC criteria have the power to create strong incentives for institutional change. These incentives will work best when they reward policy changes that create and fortify institutions that enable economic prosperity. With prosperity comes not only an increase in per capita income, but also the ability of newly empowered individuals to purchase and create all manner of socially beneficial outcomes. However, in several instances the MCC confuses the *causes* of development with the *consequences* of development. This is apparent in three important aspects of the *FY06 Report on Criteria and Methodology*, which we suggest need to be addressed and corrected. Failing to do so risks creating powerful incentives for candidate countries to enact policies that hinder economic progress and at the same time fail to achieve the goals they intend.

History teaches that economic development precedes environmental quality, health, and quality education. These are the consequences of development, not its causes. Development practitioners have made this mistake for years, employing some version of an "if we build it, growth will come" theory of development. This has led to the well-documented "white elephants" of the developing world – massive infrastructure projects and ineffective, burdensome regulatory apparatuses that lack the institutional foundation that make similar projects effective in developed countries. [17]

If the MCC encourages countries to focus on investments in these areas, it will doom candidate countries to further economic stagnation and decline, and these countries will fail to achieve higher environmental quality, better health, and higher quality education. Because the indicators are a source of strong incentives for candidate countries, focusing on the wrong indicators raises the incentives to carry out the wrong policy changes.

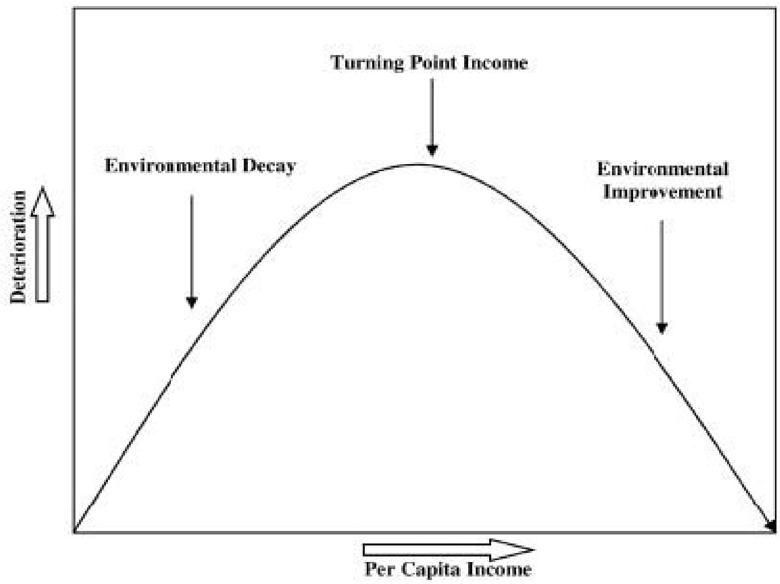
Environmental Quality

In the *FY06 Report on Criteria and Methodology*, the MCC stated that it seeks an indicator for "Natural Resource Management." However, evidence and theory both suggest that natural resource management is a consequence and not a cause of economic growth. It is because income

[16] Millennium Challenge Act of 2003 (Public Law 108-199, 22 USC 7706), § 602(2).
[17] See, inter alia, Peter T. Bauer, *The Economics of Underdeveloped Countries*, University of Chicago Press (1957); Peter T. Bauer, *Equality, the Third World and Economic Delusion*, Princeton University Press (1983); William Easterly, *The Elusive Quest for Growth*, MIT Press (2001), chapters 2 and 3; William Easterly, "The Utopian Nightmare," *Foreign Policy* (September/October 2005), pp. 58-64.

per capita increases that more resources can be allocated to better management of natural environment and the environment.

Scholars have documented the existence of what is known in the literature as an “environmental Kuznets curve,” which shows that environmental quality tends to decrease in the early stages of economic growth and that as countries become wealthier they are able to improve their environmental conditions.[18] Research has shown as countries become wealthier, they are able to “purchase” better environmental quality and natural resource stewardship. As one study puts it, “GDP growth creates the conditions for environmental improvement by raising the demand for improved environmental quality and makes the resources available for supplying it.”[19]



From Yandle, Bhattarai, and Vijayaraghavan (2004).

Natural resources are best managed in circumstances where institutional incentives exist to encourage responsible stewardship. A robust institutional environment including definition and enforcement of property rights is a pre-condition for good management of natural resources, not a consequence of it.[20]

Including a “Natural Resources Management” indicator that seeks to measure overall environmental quality would create a powerful disincentive against the early thrusts of development, which tend to create environmental problems that are rectified after the accumulation of a modest amount of wealth. This would, in fact, act as a tax on development and

[18] See, inter alia, Mariano Torres and James K. Boyce, “Income, Inequality, and Pollution: A Reassessment of the Environmental Kuznets Curve,” *Ecological Economics* 25 (1998), pp. 147-160; Bruce Yandle, Madhusudan Bhattarai, and Maya Vijayaraghavan, “Environmental Kuznets Curves: A Review of Findings, Methods, and Policy Implications,” PERC Research Study 02-1 Update (April 2004).
[19] Yandle, Bhattarai, and Vijayaraghavan (2004), pg. 29.
[20] See, inter alia, Douglass C. North, *Understanding the Process of Economic Change*, Princeton University Press (2005); Karol Boudreaux, “The Role of Property Rights as an Institution: Implications for Development Policy,” *Mercatus Policy Series* Policy Primer 2 (May 2005); Daron Acemoglu, Simon Johnson, and James Robinson, “Institutions as the Fundamental Cause of Long-Run Growth,” NBER Working Paper 10481 (May 2004), available at <http://www.nber.org/papers/w10481.pdf>.

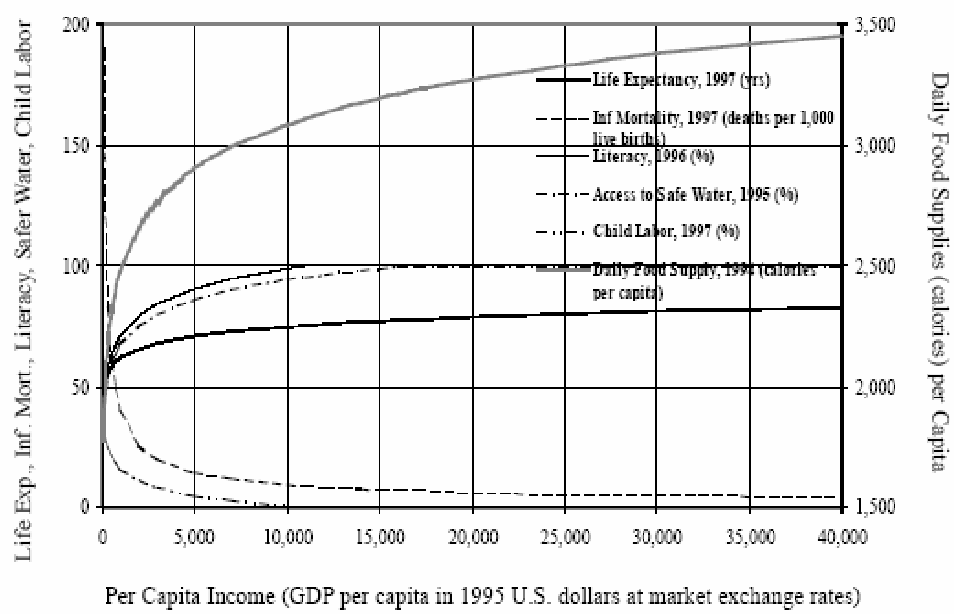
would thus retard growth. As one report argues, "Putting brakes on economic growth in the developing world is not an acceptable, or even wise, response to the pressing environmental concerns of our time."[21]

Better Health and Education

A similar confusion between causes and consequences arises in the case of health indicators and the search for a "Women's and Children's Health" criterion. While women's and children's health is very important, the rise in health is a consequence of economic development rather than a cause. It is because resources are created through entrepreneurial activity that more of them can be allocated to better health.

Historically, we see that wealthy countries provide better health care and that health improves over time as countries emerge from poverty. As Peter Boettke explains, "[T]here can be no denying that citizens of the western democracies have experienced a tremendous increase in their health and well-being over the last century. This is not true for their counterparts in less developed countries and transition economies. Life expectancy, infant mortality, nutritional intake, and sanitation are positively correlated with economic freedom, and negatively correlated with government control over economic decision-making."[22]

Well-Being vs. Wealth in the 1990s



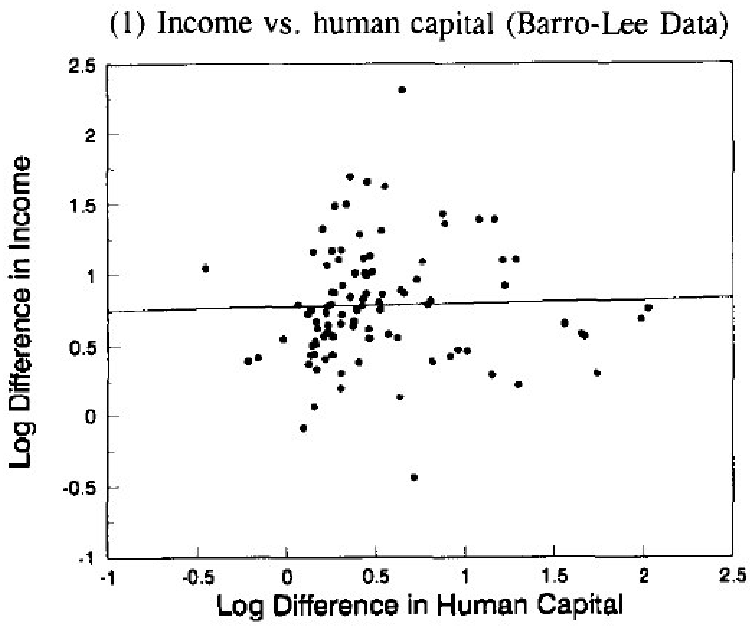
Source: Indur M. Goklany, *Economic Growth and the State of Humanity* (Bozeman, Mont.: Political Economy Research Center, 2001), using data from World Bank, *World Development Indicators 1999* (Washington: World Bank, 1999).

[21] G.M. Grossman and A.B. Krueger, "The Inverted-U: What Does it Mean?" *Environment and Development Economics* 1 (1996), pp. 119-122.

[22] Peter Boettke "Command and Control vs. Open-Ended Discovery: The Case of Human Longevity," Testimony presented for the Senate Special Committee on Aging, *The Future of Longevity: How Vital are Markets and Innovation* (3 June 2002), pg. 2.

Indicators that incentivize procedural changes or large investments in health, but do not address deficiencies in the institutions that enable prosperity and allow people to demand and purchase better services or increase accountability for decision makers in charge of administering health care services, are not likely to be successful in improving the quality of health care provided in a country.

The same is true of education and of the "Public Primary Education Spending as a Percent of GDP" indicator, for instance. Education is not a pre-condition to development but a result of increasing living standards, which is why education-based development programs to date have been largely ineffective.[23] Education becomes valuable when it is rewarded with opportunities to use it.



From Benhabib and Spiegel (1994).[24]

As William Easterly put it: "[I]t may come as a surprise – it did to me – to learn that the growth response to the dramatic educational expansion of the last four decades is distinctly disappointing. The failure of government-sponsored educational growth is once again due to our motto: people respond to incentives. If the incentives to invest in the future are not there, expanding education is worth little. Having the government force you to go to school does not change your incentives to invest in the future. Creating people with high skill in countries where the only profitable activity is lobbying the government for favors is not a formula for success. Creating skills where there exists no technology to use them is not going to foster economic growth."[25]

[23] Jess Benhabib and Mark Spiegel, "The Role of Human Capital in Economic Development: Evidence from Aggregate Cross-Country Data," *Journal of Monetary Economics* 34 (October 1994), pp. 143-173.
[24] This graph from Benhabib and Spiegel (1994), using data from Robert Barro and Jonh-Wha Lee (1993), shows that there is no significant correlation between change in education and change in income. That is, there is no evidence to show that the increase in one factor is associated with an increase or decrease in the other.
[25] Easterly (2002).

By mandating the consequence of development, the MCC asks countries to do the impossible – emulate the results of the developed world before becoming developed. In attempting to do so, countries are asked to shoulder enormous economic hardship and enact growth-retarding policy, making the achievement of some of the ultimate goals of development (health, education, and environmental quality) unattainable.[26]

In other words, it is only through institutional changes that enable prosperity that improvements in the quality of life, such as a better environment, will become reality.

B. Legislative Intent

It is also important to note how these proposed actions in the *FY06 Report on Criteria and Methodology* relate to the clear intent of Congress and the President, as articulated in the authorizing legislation.[27] The proposed "Natural Resources Management" indicator is particularly questionable and requires a leap in logic significant enough to warrant special attention.

The Millennium Challenge Act sets forward three broad criteria for the MCC to consider when evaluating a country's policy environment and making a determination regarding its eligibility to compete for funds: "Economic Freedom," "Ruling Justly," and "Investing in People." Within each of these categories, the Act enumerates specific issues to be considered when crafting eligibility indicators.

In defining the appropriate purview of the Board of Directors in considering a country's commitment to policies that encourage economic freedom when making eligibility determinations, the Act states:

> A candidate country should be considered an eligible country for purposes of this section if the Board determines that the county has demonstrated a commitment to: …
>
> Economic freedom, including a demonstrated commitment to economic policies that –
>
> (A) encourage citizens and firms to participate in global trade and international capital markets;
> *(B) promote private sector growth and the sustainable management of natural resources*;
> (C) strengthen market forces in the economy; and
> (D) respect worker rights, including the right to form labor unions.[28]

This is where the impetus for the public process to develop a "Natural Resource Management" indicator to be inaugurated in FY07 as proposed in the *FY06 Report on Criteria and Methodology* originates in the text of the authorizing legislation. To date, that process has produced a set of preliminary recommendations for items to include in a composite indicator.

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[26] This is an empirical example of a well-established idea. As F.A. Hayek wrote, "The pursuit of unattainable goals may prevent the achievement of the possible." (F.A. Hayek, *Law, Legislation and Liberty*, Volume II, University of Chicago Press [1976], pg. 133.)
[27] Millennium Challenge Act of 2003 (Public Law 108-199, 22 USC 7706).
[28] Ibid, § 607(b). Emphasis added.

Among these recommendations are:

1. The percentage of protected area in a country;
2. The amount of forest cover and the change in that cover;
3. Implementation of the Convention on International Trade in Endangered Species (CITES); and,
4. Improved sanitation (both urban and rural).[29]

In the initial process of discussing these indicators, the Natural Resources Working Group combined these quantitative factors with "qualitative discussion" to "basically an average, above average, below average, or a substantially below average rating to each of these countries as part of the selection."[30]

Two issues arise regarding a disconnect between the efforts proposed in *FY06 Report on Criteria and Methodology* and the intent of legislators, who included a requirement that the MCC pay attention to "economic policies that promote private sector growth and the sustainable management of natural resources" within the context of "Economic Freedom."

First, it is unclear how a "Natural Resources Management" indicator that takes the above factors into account has anything to do with economic freedom. The legislation pairs the concern for the management of natural resources in the same phrase with a concern that the MCC be attentive to policies that promote private sector growth, in the context of policies that encourage economic freedom.

Through the lens of economic freedom, the phrase more appropriately indicates that the MCC should be concerned with a country's allocation and enforcement of property rights that enable private actors to be responsible stewards of natural resources than it does an attention to a country's compliance with an international treaties regulating trade in endangered species and the like.

By ignoring this connection to the legislation, the MCC not only oversteps its mandate, but risks ignoring significant issues in the realm of natural resource management related to the encouragement of private sector growth. Namely, this ignores what has come to be known in the economic literature as "the natural resource curse," or the phenomenon that countries with large endowments of natural resources (such as oil) that concentrate those endowments in the hands of government, thereby restricting economic freedom and voluntary transfer of property rights in those resources, tend to lack diverse economic activity, fail to encourage industry, and maintain high levels of poverty.[31]

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[29] Comments by Christine Todd Whitman, Natural Resources Working Group Public Meeting (28 February 2005), Washington, DC.

[30] Comments by Margaret Kuhlow, Natural Resources Working Group Public Meeting (28 February 2005), Washington, DC.

[31] This phenomenon, closely related to the "Dutch Disease," is well documented in the literature. One author notes that is "much more than a theoretical possibility: large oil inflows… had exactly this effect in Nigeria between 1973 and 1986, and ultimately nearly destroyed the agricultural sector." (Steven Radelet, *Challenging Foreign Aid: A Policymaker's Guide to the Millennium Challenge Account*, Center for Global Development [May 2003].) For deeper analysis of this phenomenon see, inter alia, Peter Heller and Sanjeev Gupta, "Challenges in Expanding Development Assistance," IMF Policy Discussion Paper PDP/02/5 (2002); Jeffrey Sachs and Andrew Warner, "Natural Resource Abundance and Economic Growth,"

This is a misguided effort and a missed opportunity to send a signal that government ownership of natural resources constrains economic freedom and that countries that insist on such policies will not be rewarded.

A second concern with this step toward developing a "Natural Resource Management" indicator is the working group's inclusion of issues such as urban and rural sanitation and compliance with an international treaty on the trade in endangered species, issues clearly outside the realm of "natural resources."

At best these are broad issues related to a country's stance on how to deal with environment and wildlife concerns broadly. While these may be laudable intentions on the part of countries that score well by these measures, it is unclear that there is any legitimate legislative basis for the MCC to venture into making determinations about the eligibility of a country to receive development funds based on these factors.

When the MCC veers away from the intent of its authorizing legislation it risks becoming redundant and ineffective relative to alternative approaches to advancing these new goals. Such mission creep also tends to make effective decisions toward the ultimate measure of success for an organization, in this case the reduction of poverty, less likely.

C. Recommendations

We suggest a strict test for any additional criteria, including a "Natural Resource Management" indicator and the others signaled by the MCC in the *FY06 Report on Criteria and Methodology*. Specifically, decision makers at the MCC and their counterparts with oversight duties in Congress should ask a simple question about each new proposed indicator: *How does knowing more about this aspect of a country's policy help us to know more about a country's commitments to enable or discourage economic growth?*

If this cannot be answered with a high degree of certainty, however laudable the social goal that the action or policy in question intends, chances are it is beyond the purview of MCC. A responsible step further regarding the eventual "Natural Resources Indicator" would be to ask: *How does the country's policy in question advance or constrain economic freedom in that country?* At the very least, the Board should require that the burden of proof be borne by those who advocate the changes, and not presume that a connection indeed exists.

The "expert panel" cited by the Natural Resources Working Group is a disappointing retreat from an otherwise transparent process, and we would suggest that whatever decision the MCC reaches with respect to this new indicator, a full analysis of its connection to economic growth enhancing policies and its relation to economic freedom be released and subjected to peer review and outside comment.

Harvard Institute for International Development (November 1997). For a study of how one country endowed with significant mineral wealth managed to overcome this trap, see Susan Anderson, "Botswana: Land of Paradoxes," *Mercatus Policy Series* Country Brief 1 (February 2005).

Allowing actions that qualify as mission creep not only threatens the effectiveness of the MCC overall, it may, as in the case of encouraging a misallocation of investment and priorities, actually work against the MCC's mission to reduce poverty through growth.

D. Simplicity vs. Effectiveness

We would like to tender a final note on a trend we have observed within the decision processes at the MCC. The MCC uses various criteria to select indicators to determine country eligibility, and among them is the idea that an indicator should be "actionable," meaning that a country can directly impact the indicator through the policy process. Indeed, it is imperative to have indicators that are actionable and whose outcomes can be easily measured.

Indicators such as "Days to Start a Business" allow the MCC to show results quickly and in this sense test and validate an underlying hypothesis behind the MCA: countries will respond to the incentives created by the indicators.

However, there is a risk that in selecting indicators that are actionable and easily measured, the MCC may also be selecting indicators that are merely "procedural" and do not adequately reflect the policies and actions that truly affect the economic life for the citizens in a country. Procedural aspects of an economy are policies that governments can easily manipulate (because they control the procedures) without actually having to undergo any substantive institutional change.

It is likely that actionable and simple measures of economic policy that act as good proxy measures of an overall entrepreneurial environment today will become less useful over time as governments learn how to manipulate procedures to improve their standing on paper but make little change in reality.

For instance, whereas the "Days to Start a Business" indicator may have been a good way to take the temperature of the overall entrepreneurial environment in 2005 and 2006, we may find that as governments catch onto the fact that funding decisions are being made according to this measure, the official number of days to start a business will decrease, but the true barriers to entrepreneurs will remain, migrating to a different area where the sunlight of world attention has yet to shine.

In contrast, more complex indicators that are harder to manipulate with mere paper changes may measure the more deep-seated institutional context and be more difficult to "game." These indicators will be less "digestible," and the results of good decisions may take several years to be seen. However, they are a good check against manipulation of the system. It is important not to focus too much on simplicity if this comes at the price of effectiveness.

In measuring economic freedom, for instance, if the goal is to measure the effectiveness of economic policies as they relate to enabling entrepreneurship, it is important to not simply measure the official costs of start-ups or the number of days it takes to register a new business, but also look to more complex aspects of the entrepreneurial environment, such as the cost of exit, quality of regulation and regulators, and barriers to hiring new employees.

It should be noted that in the *FY06 Report on Criteria and Methodology* the MCC has kept "Regulatory Quality" – a fairly complex measure – in its "Economic Freedom" category, which is a good decision. It keeps the balance between simple (but manipulable) indicators, and more complex (and more robust) ones. We encourage a similar vigilance and responsibility to this concern going forward.

Conclusion

The MCC's *FY06 Report on Criteria and Methodology* improves on the United States' commitment to reducing poverty through growth by continuing to challenge the conventional wisdom in the development community.

One of the MCC's core principles – that economic progress will result when countries enact policies that facilitate good institutions – is supported by an approach that locates incentives at the heart of the organization's vision. The indicators the MCC has chosen to use to determine country eligibility for FY06, for the most part, send good signals to would-be-eligible countries that economic freedom is a requirement for countries wishing to access MCA funds.

However, this signal risks becoming muted and confused if the MCC does not weather several significant challenges in the coming year. Politically expedient choices that satisfy congressional appropriations cycles and interest groups within Washington threaten to hollow out the MCC in the long term, dashing the promise this new development venture holds.

While the inclusion of the "Cost of Starting a Business" indicator and the explanation that the MCC seeks to reward countries that create hospitable entrepreneurial environments are steps in the right direction, several other aspects of the *FY06 Report on Criteria and Methodology* create reason for concern.

The working group charged with developing a "Natural Resource Management" indicator must drastically shift course if it is to come in line with the intent of the legislation that empowers it. This and other efforts to develop indicators must not confuse the consequences of development – good health, quality education, and a clean environment – with the cause of development – quality institutions that promote economic freedom and entrepreneurship. To do so would be to forego the social benefits development brings as well as economic progress in the very countries the MCC seeks to empower and assist.

As the MCC goes forward, its task is complicated by a Washington culture that may not yet be ready to deal with an agency based on rewarding results rather than funding inputs. The leadership of the MCC has a formidable challenge ahead. By holding fast to its mission and continuing to encourage policies that enable entrepreneurship throughout the developing world, the poor in those countries may yet experience the benefits the western development community has been promising for so many years.